

UTILITIES CAN CONTROL PRIVATE SECURITY:

CHALLENGING THE OBSTACLES AND OPPORTUNITIES

Lee A. Jones, Support Services Group, San Clemente, California

Severe fragmentation, low market penetration and sustained 10-20% annualized growth all point to the private security industry evolving into the equivalent of another "utility" industry that could generate over \$200 billion annually.

Utilities have an incomparable marketing platform.....100% market share of 100% of all households and businesses for hundreds, maybe even thousands of square miles. And they have been holding that position, uninterrupted, for decades. That should make them the ideal candidate for diversification into the private security business. But why are, or why should, the "utilities" be interested in the alarm security industry? It's a question that the insiders of the security business have been asking, and this article will shed light on this issue by exploring the obstacles and opportunities preventing (or enabling) utilities from controlling the entire market.

WHO IS DOING WHAT

As of mid 1997, Western Resources (electric) had invested over \$1 Billion in the alarm industry. Entergy (electric) has invested over \$100 Million. Ameritech (telephone) has announced alarm security investments of over \$500 Million. Other electric utilities that have announced their intentions to be in the private security industry include Edison International, Arizona Power, MidAmerica Power, Southern Company, PacifiCorp, Nipsco, Southwestern Bell, Tampa Electric, UtiliCorp and Wright-Hennipen. Telephone utilities with some experience or exposure include AT&T, MCI, New England Telephone, Sprint and Roseville Telephone.

PROFILE OF THE ATTRACTION

The "private security industry" produces over \$100 Billion annually from more than 26 different business groups within the United States. The "alarm security industry" is just one of those business groups, producing \$16 Billion annually from 14 million user customers, all of which are serviced by 10,000 alarm dealers. The overall market can be divided into two broad market segments, "residential" (subdivided into at least 6 sub-segments) and "non-residential" (sub-divided into at least 4 sub-segments). Market penetration for moni-

tored residential security market averages 11% (or 10 million users) and about 50% penetration for non-residential (or 3 million users). Twenty-five of the largest dealers control 25% of the customers. The next 1,000 dealers control 60% of the customers, and the remaining 9,000 dealers control 15% of the customers.

THE OPPORTUNITY

Severe fragmentation, low market penetration and sustained 10-20% annualized growth all point to the private security industry evolving into the equivalent of another "utility" industry that could generate over \$200 billion annually. The United States and most other countries around the globe now have a desperate need for low-cost, private security. The alarm security alone is expected to produce 25 million new and retrofit customers just in the United States before the year 2005. The powerful marketing platform of the electric utility industry (the one that still exists in 1997) provides a unique opportunity to

SECURITY MARKET

money in alarm security. Peers of Warner Amex, not knowing the Warner Amex strategy, followed blindly because they didn't want to miss out on the (unknown) opportunities (i.e., if Warner Amex is in the alarm industry, we need to be there, too). Warner Amex accomplished its objective, which was to use security as a marketing tool to win key city franchises, whereas most of the peers lost focus and wasted much of their time and money. Alarm security was not compatible with CATV as part of the "bundle of services."

Mistake #2: Outsource to alarm industry mentors. There were no mentors in the alarm security industry suitable for CATV to follow. Nearly 15,000 alarm dealers had less than 8% of the residential market penetration and were so fragmented that it was even difficult for competitors to hold intelligent conversation with each other. Most security alarm companies did not even have the marketing and management skills to grow and manage their own business. Consequently, adding greater responsibilities to these small companies collapsed most of their business plans. CATV system operators ended up taking control themselves. After losing considerable time, and at great expense, most CATV operators made a complete exit.

ERA OF ELECTRIC DEREGULATION VS. CATV

The profile of the alarm security industry has experienced some change in the last ten years, but very little compared to other communications industries. The overall dynamics that impact success/failure have changed very little, too. The booby

traps are still very well hidden. Now that we have entered the era of deregulation for electric utilities we could see some of the same mistakes the CATVs experienced, and for the same reasons. Or we could learn from those mistakes and shorten the learning curve, which is basic business planning – know what you want to do, know why you are doing it and know how you are going to do it.

BUY VS. BUILD VS. ALLIANCE

Of the three options for market entry, most new investors make entry via acquisitions. Buying and consolidating existing firms and/or customers are considered the fast and easy way to reach critical mass. Building from a pure startup is generally the hardest and slowest entry strategy. Alliances with existing firms can be a good balance between buying or building.

Buy Strategy: Several experienced analysts of the private security industry can produce evidence that the traditional alarm security industry is seriously "broken" and needs considerable "fixin'." Buying into the market could be high risk and counter-productive due to all its excess "baggage." It could be more difficult to buy and fix the problems than to start from a fresh position. Included in this baggage are:

- ★ Low residential market penetration, i.e., low marketing skills
- ★ Severe fragmentation among thousands of dealers
- ★ Minimal technology and operational standardization
- ★ Non-standard state licensing and local regulations
- ★ Police relations very weak and getting weaker
- ★ Heavy government subsidy (free response) going away

★ Technology of embedded base requires costly retrofit

Build Strategy: Due to low overall market penetration and the "baggage" referenced above, the greatest opportunity in the alarm security industry is new customer creation, not existing acquisitions. Focus on the next 20 million fresh new customers rather than recycle the 10 million tainted existing users. The unparalleled marketing platform of most electric utilities will make it easier to create new customers faster, at lower cost and higher quality than through acquisition and consolidation. The time is right for a paradigm shift.

Alliances Strategy: The alarm security industry still does not now have many viable leaders and mentors. Continuation of most traditional alarm industry business plans and strategies will surely produce the traditional high cost for low quality. Utilities are positioned to quickly and painlessly take a leadership position. However, it would be a mistake to completely ignore and bypass the traditional industry. Utilities should develop the strategy of the paradigm shift, then seek alliances with traditional players for support where appropriate to shorten the learning curve. It cannot be stressed enough that the primary reason for the "incompatibility" is the difference in the marketing platform. The differences are so great that it would be too much of a quantum leap for most of the current players to offer leadership. Fortunately, the last few years of consolidation have attracted new management skills and business strategies from outside the industry, which is producing a new generation of "alliance" partners.

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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of Petition of Ameritech For)
Forbearance From Enforcement of Section)
275(a) of the Communications Act of 1934,)
As Amended)

Affidavit of Gerald J. DeNicholas

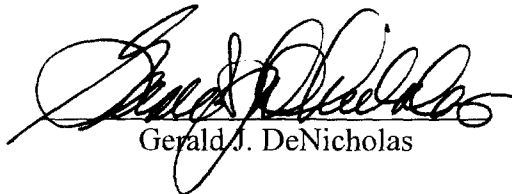
STATE OF ILLINOIS

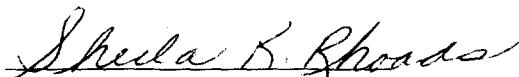
COUNTY OF DUPAGE

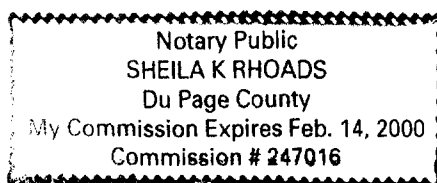
On this the 8th day of May, 1998, before me, a notary public for the state and county aforesaid, personally appeared Gerald J. DeNicholas, who acknowledged himself to be the Vice President of Business Development and Strategy of SecurityLink from Ameritech, Inc. ("SFA"), a Delaware corporation, and that he, as such Vice President of Business Development and Strategy, having first duly sworn according to law, deposes and states as follows:

1. That on June 28, 1996, SFA acquired the alarm monitoring assets of the Home Security Division of Circuit City Stores, Inc., a company whose principal business involves operating retail stores specializing in audio and video equipment and appliances. Three months later, SFA acquired the assets of Castle Guard Security, Inc., a small company with accounts primarily in the Kansas City metropolitan area. In April, 1997, SFA acquired the alarm monitoring assets of Central Control Alarm Co. and Norman Security Systems, Inc., the latter after a competitive bidding process. On June 19, 1997, after a competitive bidding process, SFA acquired the alarm monitoring assets of Masada Security, Inc. On October 3, 1997, after a similar competitive bidding process, it acquired the alarm monitoring assets from six subsidiaries of Republic Security Companies Holding Co., II, Inc. On the same day it acquired the assets of the alarm monitoring division of Rollins, Inc., also in a competitive bidding process.

2. Other than the Circuit City and Castle Guard transactions, which were of modest size, each of these acquisitions was submitted for antitrust review by the Department of Justice and Federal Trade Commission under the Hart-Scott-Rodino Act. Neither agency raised an objection to any of the transactions.
3. SFA has integrated all of the acquired assets into its existing operations and has had no ongoing relationship with any of the selling companies.
4. Approximately 75% of SFA alarm monitoring customers are located outside of Ameritech's telephone service area.
5. Prior to the enactment of the Telecommunications Act of 1996, Ameritech had invested hundreds of millions of dollars in reliance on its ability to compete on an equal footing in the alarm monitoring industry.
6. SFA has the ability to bring efficiencies and consumer benefits to the marketplace. This is evidenced by the reduction in equipment cost that SFA was able to achieve with its buying power. These cost benefits were passed on to customers in lower prices for security systems. In addition, SFA has made security services available to the mass market with its no money down installation programs. In addition, Ameritech has invested more than \$13 million in the construction of a state-of-the-art monitoring facility in Bradenton, Florida. This facility is one of the most advanced facilities of its kind in the industry. Consumers will receive the highest quality of service with a broader range of options at affordable process. Ameritech's investment would have been impractical and the facility would not have been built, if SFA had not been able to engage in large scale growth through asset acquisitions. It is only because of the economies of scale that accompany consolidation that this investment became prudent.


Gerald J. DeNicholas


Notary Public



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BUSINESS

BRADENTON HERALD • WEDNESDAY, FEBRUARY 25, 1998 / PAGE 9

STORY IDEAS

Send business news to P.O. Box 921, Bradenton, FL 34206.

SecurityLink operations center nearly complete

SHELLY SMOO

Herald Business Writer

Manatee County is one of four locations in the nation where state-of-the-art security monitoring facilities will be operated by SecurityLink, a division of Chicago-based Ameritech Corp.

Company officials said Monday they will close 19 monitoring centers in North America to help the telecommunications firm bring operations closer together and operate more efficiently after a number of acquisitions in the last two years.

Under the consolidation plan, central monitoring will be done from facilities in Bradenton, Birmingham, Jacksonville and Toronto, Ameritech spokesman Rich Maganini said.

Work nearly is complete on a 100,000-square-foot, two-story, state-

"The Bradenton facility is definitely one of our major monitoring centers. We intend to have about 500 employees by the end of the year and up to 1,000 over the next few years."

Rich Maganini

Ameritech spokesman

of-the-art, monitoring center in south Manatee County adjacent to Interstate 75 near University Parkway.

Ameritech, a Bell company, bought several firms, including Republic Industries Inc., for \$610 million cash last fall, to make its SecurityLink division the second largest monitoring company after ADT Inc.

A federal telecommunications law that passed a year ago prohibited regional Bell phone companies from operating home security businesses until 2001, but the law grandfathered in Bell companies already in the security business.

The only Bell company in home security when the law passed was Ameritech.

Analysts believe the business is a natural extension of services for telephone companies looking for ways to boost revenues.

"At some point, the big phone companies will dominate this business," predicted Robert Rosenberg, president of Insight Research Corp., a marketing firm in New Jersey. "You can do home health monitoring, alarm monitoring, smart house telemetry and other value-added business on the same network."

Ameritech's decisions to consolidate will benefit areas with monitoring facilities. As the company decides how to manage its workforce, more jobs could become available.

Some workers at closed facilities have been offered jobs at those remaining open, but Maganini said the Manatee County facility expects

to hire most of its workers locally within the market from Tampa to Sarasota.

"The Bradenton facility is definitely one of our major monitoring centers," Maganini said. "We intend to have about 500 employees by the end of the year and up to 1,000 over the next few years."

Carpeting, file cabinets, furniture and computer terminals now are being installed in the Manatee County facility.

The company will do some operations in the new building by the second quarter and actual security monitoring by mid-year, Maganini said.

Information from the Knight Ridder/Tribune Business News wire supplemented this report.



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November 29, 1995

Business Services
Security Industry

Jeffrey Kessler
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CONSOLIDATION IS DRIVING THE SECURITY INDUSTRY

**WHAT ARE THE IMPLICATIONS OF THE CURRENT
WAVE OF ACQUISITION ACTIVITY?**

**WHY IS THE DEMAND BY CLIENTS FOR GREATER
INTEGRATION DRIVING CONSOLIDATION?**

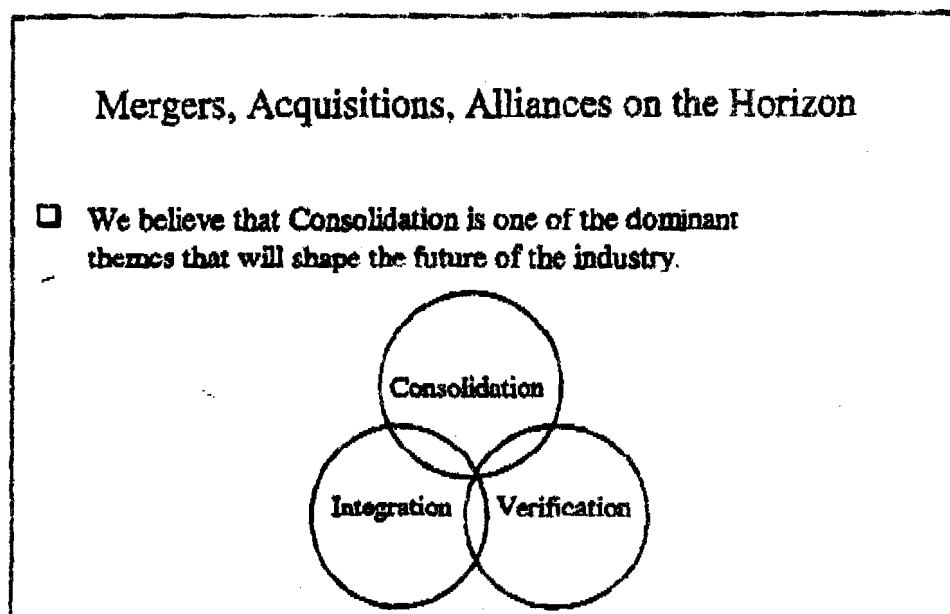
**WHAT ARE THE STRATEGIES AVAILABLE TO THE
CONSOLIDATORS AND TO THE TARGET MARKET?**

**Adapted From Our Speeches Before the Central Station Alarm
Association and the Security Industry Association, Respectively,
October 17 and November 8, 1995**

- ☐ **Consolidation/Integration/Verification** remains our operational theme driving the electronic security marketplace. As corporations increasingly move toward centralizing their security functions -- and integrating them with premises control -- pressure grows to become big enough in scope to keep up with the clients.
- ☐ **Increasing value-added offerings works.** Equipment suppliers become systems suppliers and not only gain market share, but increase their margins. Services (monitoring) companies can leverage off increased "menus" of services, and increase their users' loyalty.
- ☐ **The various groups of potential acquirers** -- from outside and inside the industry -- have specific goals in mind for adding security services to their product offerings. Similarly, for the companies being looked at, several strategies apply to conducting business in a world that is consolidating. All the strategies have considerations attached to them; however, that should make buyers and potential sellers think long and hard.
- ☐ **How do the public companies we cover** -- ADT (ADT - 14, Rated 2), Pittway (PRYA - 61, Rated 2), Pittston Services (PZS - 29, Rated 2), Sensormatic (SRM - 22, Rated 2), Borg Warner Security (BOR - 11, Rated 3) -- fit into this scenario?

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**Figure 1: Consolidation Is Driving The Security Industry
Mergers, Acquisitions, Alliances on the Horizon**



**OUR RECURRING
THEME:
INTEGRATION,
CONSOLIDATION,
VERIFICATION**

We have spoken previously about the need to confront three trends which we felt would be the theme for security in the 1990s (Figure 1) -- namely, Consolidation, arising from the need for Integration and Verification. In brief, the trend toward centralizing the security function in the hands of executives at the corporate level, rather than at an ad hoc, site-based system, is causing commercial and institutional users to try to both centralize and outsource their security needs. For Wall Street to notice these trends, at least one of three events would have to happen:

1. ADT as a company and as a stock would have to do well;
2. Some outside force, such as a telecom or cable company would have to enter the industry; and
3. A major city would have to discontinue police response to unverified alarms by central monitoring stations.

Two have occurred. (1) ADT has done well as a company, and even better as a stock -- it has doubled within the last 18 months, (2) Ameritech has entered the electronic alarm business. The Los Angeles City Council considered, but tabled a bill to eliminate police response for unverified alarms -- one of many initiatives being considered by municipalities to lower the increasing burden of false alarms on police forces.

Of the aforementioned trends, none has taken root as strongly as the pressure to consolidate. The major topic of conversation in the industry today is *who*: it is going to look like five years hence. We have all seen headlines about very large "players" taking an interest in the business. But, what are the forces driving this change? Point one comes immediately to mind: the need to provide integrated services to ever more demanding clients, led initially by a new breed of corporate security directors.

**Figure 2: Consolidation Is Driving The Security Industry
Mergers, Acquisitions , Alliances on the Horizon**

Mergers, Acquisitions, Alliances on the Horizon

- ❑ The growth in systems integration is a critical driver of industry consolidation. Demand for systems integration is created by:

Corporate Needs

- Central managers need to exercise greater control over remote plant and office sites.
- Traditional ad hoc security purchases by local personnel have created a nightmare of incompatible systems.

Technological Advancements

- Access control and systems software have improved enough so that cost and functionality are both becoming attractive to end users.
- Systems are now understandable by end users, changing the nature of the guard business.

Demand for Integrated Services Drives Consolidation. More specifically, these directors of corporate security are asking security services and equipment companies to provide them with multifaceted solutions that are both:

- Consistent across an entire company's system, and
- Flexible enough so that individual sites can be monitored as need be (Figure 2).

In this manner, commercial security users can get away from the ad hoc purchasing of disparate security equipment by a local plant manager, historically purchased in a hodgepodge manner without thought of integration, yet still tailor security systems to the locale. We backed this up with a survey we conducted showing that over two thirds of Fortune 100 companies were actively pursuing strategies to put together, using access control software as the glue, systems that included CCTV, access control, alarms, antitheft tags, and various access control hardware (up to, and including, radio frequency identification tags).

Commodity equipment and "vanilla" alarm systems are being replaced by stand-alone security systems which are multifunctional or by security systems which are parts of larger "premises control" systems. This is being driven as much by the abilities of the equipment manufacturers and service providers, as by the demands of the end-users themselves. Commercial/industrial security systems for large accounts are already the fastest growing segments at ADT and Sensormatic Electronics.

But even small-scale security systems will benefit from integrating functions. Equipment manufacturers such as ITI and Ademco have introduced and are introducing multifunction systems priced for large home or small retail users that offer limited access control, lighting, remote functions for relatively inexpensive price points. ADT's Focus 200 Quantum is another example of a system, which, for relatively limited outlay, offers a variety of security functions for many users undreamed of in a system of moderate cost just five years ago. In other words, marketing of multifunctional security systems is here not just for the sophisticated corporate user, but at all levels, down to residential.

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False Alarm Verification. A second factor driving industry buying considerations is the rampant growth in the absolute number of false alarms. The false alarm issue is being discussed in this, and other security industry forums, seemingly nonstop: one thing is clear, the dramatic growth in residential security systems sold over the last five years has brought with it commensurate growth in false alarms. No matter what solutions are ultimately agreed upon to lower the false alarm incidence -- more privately manned response, noise discrimination, two-way voice, TVX or cheaper CCTV, or various forms of audio verification -- one thing is certain: verifying an alarm by some means before notifying the police to dispatch will likely be a requirement for any type of meaningful police response by the year 2000.

However, these aforementioned trends of Integration and Verification come with price tags attached, both monetary and strategic -- price tags we believe will cause a lot of soul searching by both the equipment and service sides of the industry. As a result, in the last two years, we have witnessed the beginnings of an industrywide consolidation phase unparalleled in the histories of the \$6.5 billion alarm monitoring industry or the \$5.5 billion equipment business. There is no need to recite what we have witnessed from Ameritech, Republic Waste, and ADT on the service side, and from Pittway and Sensormatic on the equipment side to bear this out.

**THE DYNAMIC
TRENDS DRIVING
CONSOLIDATION
IN THE SECURITY
INDUSTRY**

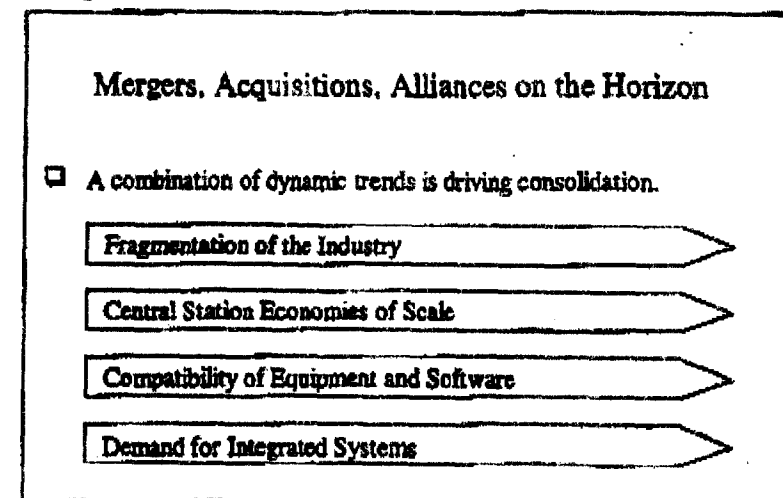
Dynamic Trends Driving Consolidation

What combination of dynamic trends are driving this industry consolidation? What are the consolidators looking for, in a candidate (Figure 3)? What are the strategic choices available to companies (Figure 4) in this industry which have to make "life style" decisions over the next five years.

As Figure 3 portrays, there are several reasons why (1) consolidation is occurring in the industry. Figure 4 shows (1) why one of the drivers is becoming critical -- namely, that large regional and national users of security can ask for more integrated systems, and (2) why security companies can now fulfill this request.

- **Fragmentation of the industry.** There are some 12,000 alarm service providers and about half as many equipment manufacturers. The average revenues of the

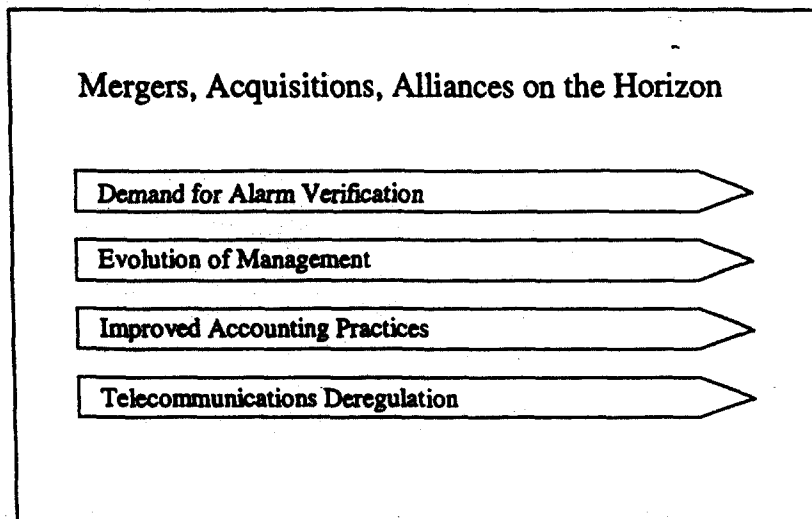
**Figure 3: Consolidation Is Driving The Security Industry
Mergers, Acquisitions, Alliances on the Horizon: Dynamic Trends
Driving Consolidation**



alarm monitoring companies is under \$1 million while the average revenue of the equipment companies is less than \$2 million. Many of these companies are second- and third-generation enterprises.

- **Central station economies of scales.** We believe that the ability to scale up is best targeted not at installation but at the monitoring function. Nevertheless, no one is going to deny that improved technology has allowed the number of clients being serviced by each central station to go up severalfold over the last 10 years. Companies from ADT to Guardian to Masada have discovered that adding residential customers to an existing commercial monitoring base can leverage existing plant.
- **Compatibility of equipment and software.** Over the last five years, consolidation among the providers of monitoring-station and MIS software, and among the major equipment suppliers to the security service industry, has made it easier for larger companies to select and integrate acquisitions targets.
- **Demand for integrated systems.** Corporate clients are asking for, and suppliers of equipment and services are being forced to offer, more complete security systems, instead of just "burglar alarms or "card readers." This requires capital and management infrastructure.
- **Demand for alarm verification.** It requires capital to offer verification of monitored alarms.
- **Evolution of management.** A combination of (1) family managements seeking more professional advice in a changing market; (2) managements that have turned from family or entrepreneurial into professional; and (3) managements that went through one or another baptism of fire in the early 1990s has given larger, outside players more confidence in the industry's ability to grow itself.
- **Improved -- or at least more decipherable -- accounting practices.** A combination of more exposure to demanding investors, more educated investors, and simple evolution has gradually improved the accounting practices of security companies, to the point that at least some of the business is decipherable to outsiders.

**Figure 4: Consolidation Is Driving The Security Industry
Merger, Acquisitions, Alliances on the Horizon: Factors Facilitating
Consolidation Within the Security Industry**



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IN THE
SYSTEMS/EQUIPMENT
SECTOR**

- **Telecommunications deregulation.** Whatever the ultimate outcome of the current telecommunications bills in the U.S. House of Representatives and the Senate, it is clear that interest and ownership by telecom companies, followed by their competitors for in-premise services, the cable companies, is a reality.

Value-Added Spurs Profit-Margin Expansion: Pittway and Sensormatic

The move toward providing more sophisticated, more integrated security systems carries with it all the typical risks of identifying, buying, integrating and running with acquisitions (Figure 5). We all know this is much easier said than done. However, for those companies that succeed, the reward is not only more business, and more market share, but higher profit margins as well. The most glaring example is the years of little or no profitability in the card-access control business. Now, with access control systems generally being used as the integrator of more complete systems, companies like Casi Rusco and Continental Instruments (now integrated with Sensormatic's Software House division) have become "value adders," instead of just equipment companies.

The most shining example of what proper consolidation can mean to a company has been Pittway's ability to move from being a leading provider of commodity, me-too alarm panels and equipment to a company heavily marketing systems sales to such companies of Johnson Controls and Trane. Over the last five years, operating margins for Pittway's security and fire division has more than doubled, to over 7% from under 3%.

Among the major fallacies we see are some public investors' lack of interest in (or dismissal of) Sensormatic's industrial business as "lower margin" relative to its original antitheft tag business. Although the gross margin of Sensormatic's commercial/industrial business is generally lower than its overall margin (approximately mid-40% versus 50%-55%), the gross margin in the company's commercial/industrial business has been rising over the past five years due to value added, while surging revenues and market share have allowed SG&A to fall dramatically against revenue. Thus, Sensormatic's "low-margin" business in 1996 may end up with a higher operating margins than that of the tag business on which Wall Street focuses.

**Figure 5: Consolidation Is Driving The Security Industry
Mergers, Acquisitions, Alliances on the Horizon**

Mergers, Acquisitions, Alliances on the Horizon

- Examples of companies acquiring to provide systems integration include:
 - Sensormatic has bought four systems integrators and now may buy some of its dealers.
 - Pittway has acquired Xetron (access control) and Javelin (OCTV)
 - Pinkerton's recently acquired two regional systems integrators: Omega Corporate Security in California and J.L. Torbeck Co. in Ohio.
 - Through acquisitions, Panasonic is adding pan/tilt/zoom and switching systems.
 - Phillips acquired Burle.

Over the last year or two, these drivers have caused a marked increase in mergers and acquisitions in the systems and equipment industry. Examples of companies acquiring to provide systems integration include:

- **Sensormatic**, which has purchased access-control systems leader Software House, Robot Research in CCTV control equipment and four leading systems integrators.
- **Pittway**, which recently acquired its own systems integrator; earlier purchases include Xetron in access control and Javelin in CCTV.
- **Pinkerton**, by acquiring California and Midwest systems integrators, has backed up our contention that the guard industry will move toward more higher "value-added" security personnel -- and higher day rates.
- **Panasonic**, which is moving toward becoming a CCTV systems producer by adding pan/tilt/zoom and switching systems -- making the transition from commodity camera producer.
- **Phillips**, the huge Dutch electronics conglomerate, which has acquired Burle Industries.

"Hot Spots" In the Equipment Industry

What types of equipment are being eyed by potential acquirers in the equipment industry (Figure 6) seeking to increase both market share and profit margins?

- **Security Systems Integrators.** Clearly, high-quality security systems integrators are being combed now by the largest equipment companies.
- **Access Control And Software.** The glue for constructing an integrated security system, the access control systems, is also a critical building block. Although software for physical access control likely will be in greatest demand, we would

**Figure 6: Consolidation Is Driving The Security Industry
Mergers, Acquisitions, Alliances on the Horizon: Equipment
and Systems Wanted As Potential Acquisitions**

Mergers, Acquisitions, Alliances on the Horizon

- ☐ What types of equipment and systems do we see as most desired by acquirers?
- Systems integration
 - Access control, including cards, biometrics and transaction/data security
 - Value-added CCTV (i.e., switching, multiplexing and transmission)
 - Alarm verification
 - GUI (graphical user interface)
 - Fire control and detection

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also closely study data/transaction software security and other forms of hardware, such as biometrics and, ultimately, smart cards and radio frequency identification cards, as acquisition targets.

- **CCTV Systems Becoming More Functional for Lower Prices.** Several CCTV companies have been acquired recently. With the acquisition of American Dynamics and Robot by Sensormatic, Burle by Phillips and Javelin by Pittway, the various remaining leaders in switching, multiplexing, and transmission technology are being looked at by the both the previously mentioned acquiring companies as well as by new potential acquirers.
- **Fire control and detection systems.** The surge in seminars at security conferences on the installation, monitoring and dispatch issues pertaining to fire equipment is probably the best example of how important this niche is becoming to the security industry. Could Pittway have increased its market share in the industry the way that it has without its fire business?
- **GUI and Verification Equipment.** Newer technologies, such as graphical user interface software, or GUI (which allows complicated systems monitoring to become simpler on a screen), and alarm verification software and equipment, appear to be the provinces, right now, of internal development. However, just as MAS has staked out a significant niche for itself in providing alarm-monitoring software, so too do we believe that the above areas will end up with outsourced product leaders.

**CONSOLIDATION
IN THE ALARM
MONITORING
INDUSTRY**

Wall Street Is Beginning to Understand

No matter how active the private investment market in alarm companies, the public market required the leader, ADT, to do well in the stock market, so as to attract broader acceptance of other companies. That ADT has done well, we believe, has attracted public capital into the marketplace, and has helped investors push for such events as a special tracking stock inside the Pittston Group of the two Brinks security companies — home security and armored transport.

From a broader perspective, ADT's success has attracted capital to the industry, which is attempting to understand in depth for the first time some of the idiosyncrasies of this business — such as, accounting procedures (ranging from how attrition is calculated to depreciation schedules).

With its fast-track learning hat on, Wall Street is beginning to understand two truths about the security industry:

- That its financials are somewhat different from the cable and paging industry -- that it requires a higher level of ongoing capital expenditure than cable, for instance. To be forthright with Wall Street, when discussing this industry, if one wants to brag about a high level of EBITDA, one must also be willing to talk simultaneously about capital expenditures and what is left over in free cash. Sometimes it's not much.
- Security, like cable, can be considered a high value-added service, and a part of an overall premises control package. The only question being, which industry, electronic security, cable, telecom, facilities management, or HVAC, will best define to users what their vision of "premises control" is.

And it is clear that outsiders have a strong interest in this industry. ADT's agreement to buy Alert Centre has been overshadowed by Ameritech's two purchases, and, to some extent, by Republic Waste acquiring Kurtz and Scott in Florida. It is well known that TCI Group has funded a small alarm company in Houston, while EDS has a small investment in a publicly held company.

Lehman Brothers has been involved in the security industry consolidation process. Among the many questions asked, the most frequent is: "What exactly are these companies looking for in entering our industry?"

Figure 7: Consolidation Is Driving The Security Industry
Mergers, Acquisitions, Alliances on the Horizon: The Consolidators

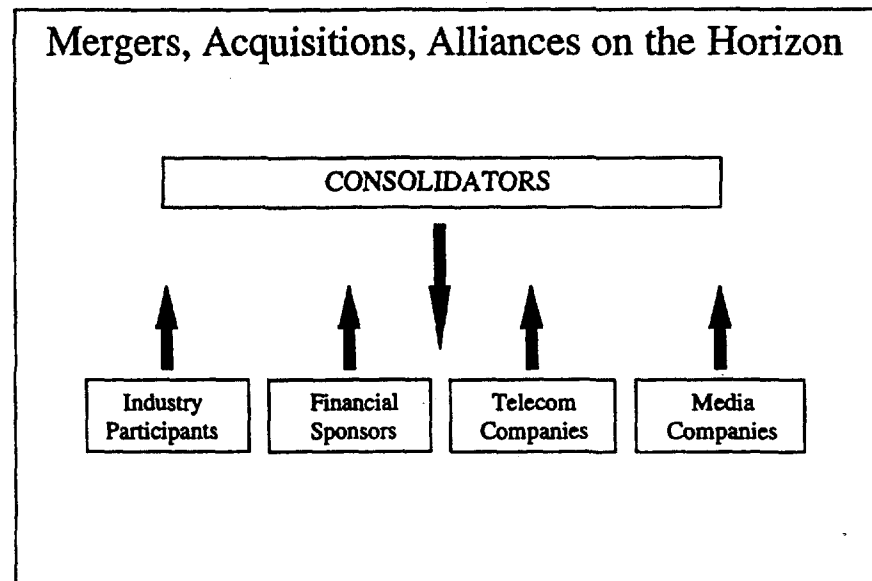
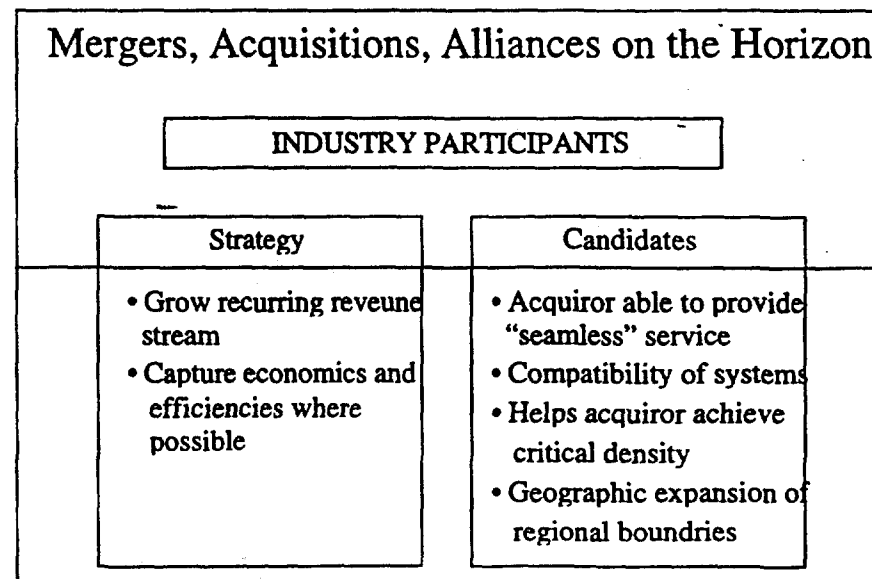


Figure 8: Consolidation Is Driving The Security Industry
Mergers, Acquisitions, Alliances on the Horizon: Industry Participants



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Who Are the Consolidators in the Electronic Alarm Industry

Four groups of consolidators are facing the electronic alarm industry today (Figure 7):

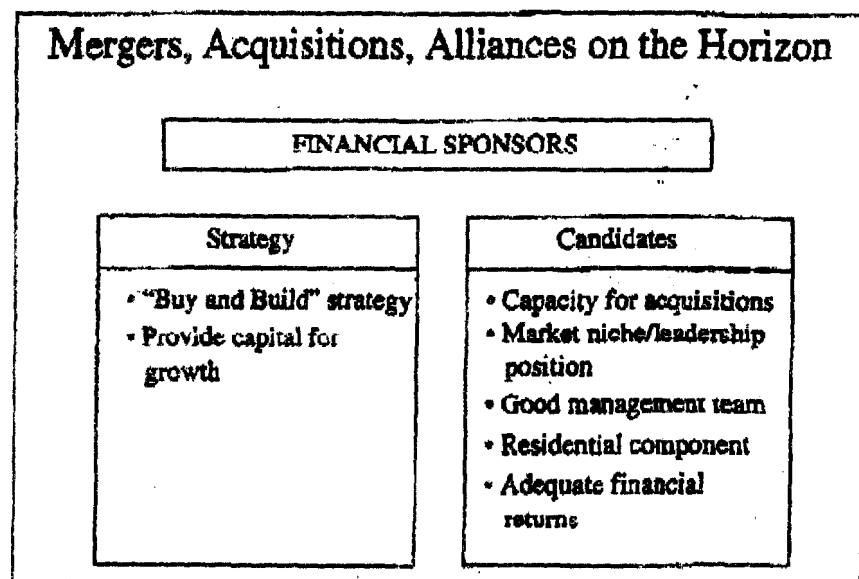
- Industry participants
- Financial sponsors
- Telecom companies
- Media companies

Industry Participants (Figure 8). When a company can add new subscribers for 20x-25x monthly recurring revenue (MRR), it takes good candidate selection and a good integrator to make an acquisition at 35x-40x MRR, and then sufficiently "rationalize and synergize" to lower the pro forma multiple down to 25x-30x. Nevertheless, for those companies which want to merge or acquire in order to generate enough EBITDA to either dominate a market or to go public, these abilities are critical.

Financial Sponsors. The nature and size of financial sponsors looking at this industry has changed drastically over the last five years (Figure 9). Previously, groups like T/A Associates, Patricof, Chemical Ventures, Bariston Partners were the mainstay of private finance behind companies. However, the entrance of Citicorp in 1994, which purchased Smith Alarm, not investing just a small amount for a small percentage of the company, changed some of the landscape, in my opinion.

Although none of the very large private pools have surfaced in the newspapers yet in connection with this industry, they are there, looking mainly for "platforms" of well-positioned companies and searching for good managements to run them. Their strat-

**Figure 9: Consolidation is Driving The Security Industry
Mergers, Acquisitions, Alliances on the Horizon: Financial Sponsors**



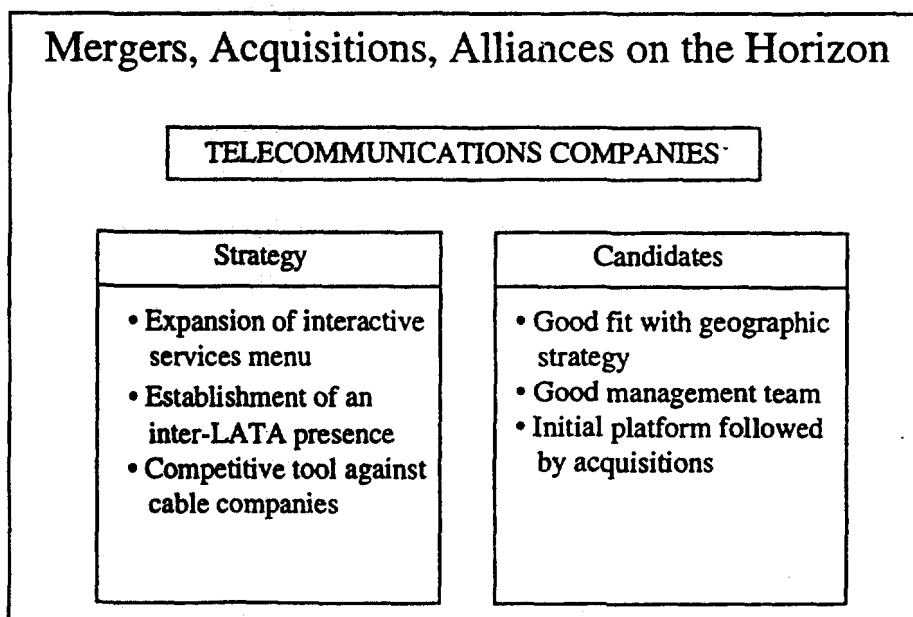
egies appear to be primarily based on providing capital for growth under a "buy and build" scenario, rather than a classic leveraged type of transaction. In addition, several of these private pools have expressed a preference for companies with large residential components..

Telecommunications Companies. It is no secret that telecom companies, like Ameritech, are interested in the security industry because they desire to expand the menu of interactive services they can offer subscribers (Figure 10). Furthermore, the addition of new services provides them with a competitive tool against the cable companies, which are looking at the industry, but are somewhat behind on the learning curve. What many don't realize is that, despite the existing and future regulations out there, pushing the envelope and establishing an inter-LATA presence, while risky, can also establish precedence and presence over a wide area that other potential entrants -- now regulated -- may have a hard time dislodging when, in several years, telephone companies are free to enter the alarm-monitoring market.

Essentially, what the telecom companies are looking for are companies with good management, because the telecoms readily admit they don't have the knowledge to operate on a day-to-day basis these very service-intensive businesses. Second, the telecom companies, unless they want to really "push the envelope," generally are looking for a good geographic fit, and an initial platform in an area, from which to make further acquisitions.

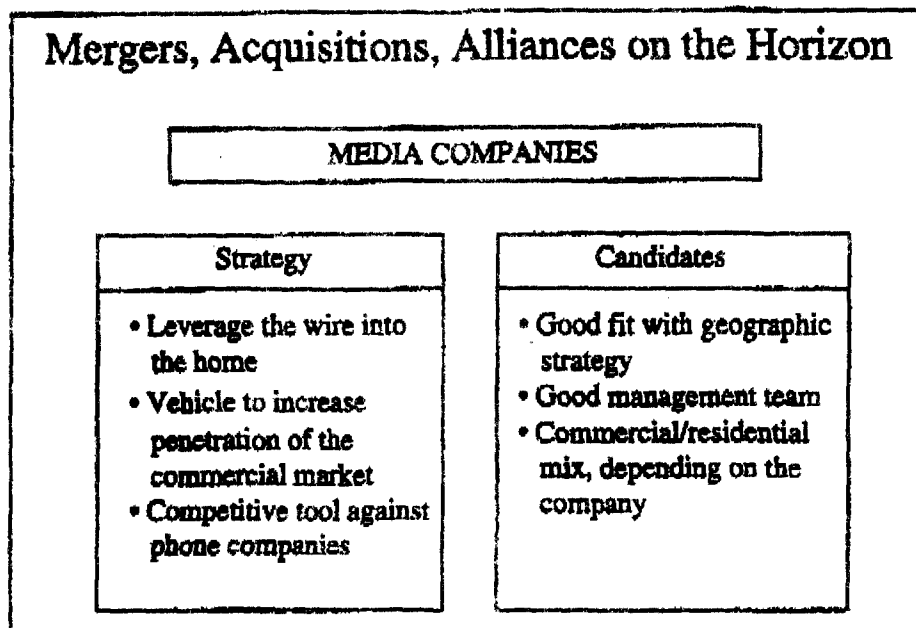
Media Companies. Except for a small operation funded by TCI Group in Texas, the cable companies are latecomers to, but very interested in, the alarm industry (Figure 11).

Figure 10: Consolidation Is Driving The Security Industry
Mergers, Acquisitions, Alliances on the Horizon: Telecom Companies



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**Figure 11: Consolidation Is Driving The Security Industry
Mergers, Acquisitions, Alliances on the Horizon: Media Companies**



Previous experiences by Time Warner and multifamily security – cable television joint ventures (Datavision, Inc., as an example) – in the early 1980s evidently soured cable operators, before they discovered that (1) security must be run by its own industry managements, and (2) in the interactive age, security can be offered as another service (as opposed to a separate business) to leverage “the wire” into a home. Obviously, cable television companies see security as a means to differentiate themselves from, and compete with, the telephone operators.

Cable companies also view security as a means to penetrate the commercial market. Until now, cable companies had seen itself in the commercial area as locked into bars and restaurants. Now, they believe that, by offering a security service to businesses, cable companies gain a possible marketing entree for other services..

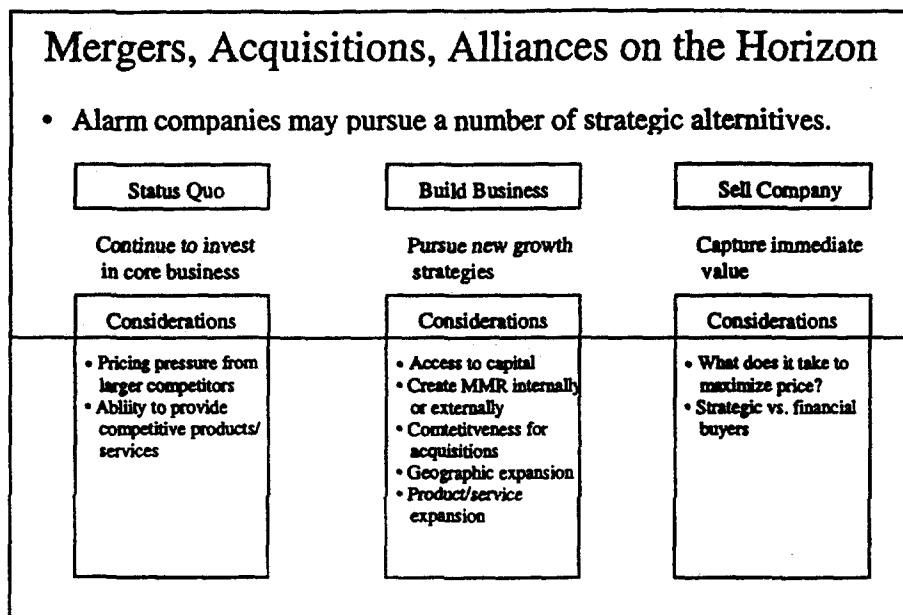
**WHAT ARE
THE STRATEGIC
ALTERNATIVES
AVAILABLE TO ALARM
COMPANY
MANAGEMENTS?**

A number of alternatives are open to alarm companies -- particularly those which view themselves as high-quality, smaller regional firms (Figure 12). All have certain advantages, but all also imply certain considerations.

Do Nothing -- Or Even Run the Business Down. One strategy, with two options, is to maintain the status quo, merely investing in the core business to keep service levels up. This can result in a continued, successful business for some time to come. However, be aware that pricing pressures, particularly on the installation end, are building in the industry, chiefly from larger companies. In addition, the major challenge a small competitor faces is the larger companies' ability to provide an array of competitive products and services. Increasingly, the larger companies are learning how to market their menu of offerings, and this may be the biggest threat of all.

An alternative to the above, and one that is viable and attractive for some, may be to run off the business, taking out cash, investing in existing customers, but not in new customers. For managements which don't have another generation to take over the reins, but which nevertheless are thinking about long-term planning, this is a workable alternative.

**Figure 12: Consolidation Is Driving The Security Industry
Mergers, Acquisitions, Alliances on the Horizon: Strategic Options**



Build the Business. Many in the so-called middle-size market wish to grow their businesses, and even combine with other companies of similar size to gain market share and certain economies of scale in a given geographic area. Certainly, the *au courant* thinking in the alarm business today is that small is not so good anymore, national is nearly impossible to accomplish, and regional or superregional is the way to go. However, there are a number of considerations which must be taken into account at this level:

- Access to capital -- stay with the bank, go the venture capital route, or go public?
- Create monthly recurring revenue internally (cheaper, but much slower), or acquire?
- If one decides to acquire, what is the competitive landscape for those acquisitions?
- In expanding geographically, does one try to saturate the State of Florida, or expand more broadly in the South?
- In expanding, how much new product and service does your company have to offer in order to be competitive: wireless backup? human response and verification? TVX or CCTV? access control, and if so, which type?

An Initial Public Offering. As always, with the aforementioned choices, access to capital becomes a critical choice. Going public is a route that can provide capital for the business and allow the owners to take out a portion of their investment. The success of ADT, and the appeal of Brinks Home Security to the investment public, will allow capital to be raised satisfactory valuations to alarm company managements, we believe. However, only a company of some size in this industry is advised to go this route. We believe a minimum of \$40-\$50 million of total revenue

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and a minimum of \$2.0-\$2.2 million of MRR is the low end at which a large, respectable investment bank will take on the task. Coming public with too small a "float" of trading shares, which is what happened with Protection One, does not allow enough trading — and therefore overall market interest — in the stock to build. Also, most of the alarm industry has little experience with marketing to public investors, both before the IPO and forever after in the public market — which can become a daunting experience. What Wall Street believes is important to your business may not coincide one iota with what you believe.

Sell the Company. Selling the company captures an immediate value.. It can also leave a lot on the table and likely ends a connection for a family which has lived with the business for years. As such, it may initially seem like a good idea, but ultimately be too much of an emotional undertaking to complete. Also, in selling a company to capture the immediate value of the market, one has to know how to market that value — similar to learning how to market your "value" to Wall Street. What does it take to maximize price in today's marketplace. That sounds like another seminar for this industry group.